U.S. Securities and Exchange Commission

Testimony Concerning Appropriations For Fiscal Year 2002

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Chairman Hollings, Ranking Member Gregg, and Members of the Subcommittee:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission ("SEC" or "Commission") in support of the SEC's fiscal 2002 budget. The SEC is a civil law enforcement agency. Since its creation in 1934, the SEC's mission has been to administer and enforce the federal securities laws in order to protect investors, and to maintain fair, honest, and efficient markets. We accomplish this mission by overseeing the markets through a public-private partnership. This system of shared regulation among the SEC, state regulators, self-regulatory organizations ("SROs"), and the securities industry enables the Commission to leverage its resources and is markedly different from the approach taken by other federal regulators. Even with this system, however, the SEC must stretch to keep pace with the rapidly changing marketplace.

The Commission today faces some of the most complex and difficult issues it has ever considered. No segment of American business has been more transformed by the rapid pace of technological innovation in recent years than the securities industry. New technologies, new participants, and new financial products are reshaping our markets. Our markets also are becoming increasingly global - a trend that most expect to accelerate in the coming years. In addition, our national securities markets are taking steps to shed their long-held membership status and are moving to become publicly held entities. In short, it is now more important than ever that the SEC remain vigilant in policing and maintaining the integrity and transparency of our securities markets.

We are a nation of investors. Twenty years ago, only 5.7 percent of Americans owned mutual funds. Today, some 88 million shareholders, representing 51 percent of U.S. households, hold mutual funds. Our nation's investors have an unprecedented stake in our markets. Whether through college savings plans or retirement accounts, our collective stake in U.S. markets continues to grow, and we are increasingly dependent on the success and integrity of those markets. In addition, online trading and new technologies have empowered individual investors in ways that were previously unimaginable. It is against this backdrop that I intend to discuss the President's fiscal 2002 budget request for the SEC and the primary challenge we currently face: our inability to attract and retain staff.

The President's fiscal 2002 budget requests an appropriation of $437.9 million for the SEC, 3.6 percent more than our fiscal 2001 enacted level of $422.8 million. This $437.9 million request, while providing the resources necessary to meet the Commission's current needs, is a zero-growth budget. It only partially funds the Commission's inflationary and mandatory cost increases, does not provide any programmatic staffing increases, and actually requires the Commission to make a small reduction in its authorized staff level.

We intend to support the Administration and meet the challenges ahead by continuing to use our existing resources as efficiently and effectively as possible. Unfortunately, and perhaps ironically, we only have the ability to operate at this funding level because of the severe staffing problems we currently face. In particular, our inability to pay staff at a level comparable with the other federal financial regulatory agencies has hampered our ability to attract and retain staff. The resulting high turnover that we have experienced has resulted in a significant efficiency loss and has left certain positions unfilled indefinitely. Because filling these positions has proven to be so difficult, we intend to fund some of our mandatory costs by making reductions in the number of vacancies that we will fill in fiscal 2002. However, constraining the SEC's growth and relying on cutting unfilled positions is not preferred and certainly is not sustainable over the long term.

The SEC will need significant additional resources in fiscal 2003 and beyond to respond to both the continuing innovations in our markets and the increasing regulatory responsibilities we face as a result of several recent legislative initiatives. In particular, we will require additional examination and oversight staff to meet our new responsibilities under the recently enacted Commodities Futures Modernization Act of 2000 ("CFMA"), which provides for joint oversight with the Commodities Futures Trading Commission of new security futures products, and the landmark Gramm-Leach-Bliley Act ("GLBA").

In addition, the SEC critically needs to stay abreast of the rapid evolution of our securities markets. New markets and new trading models are constantly emerging. Electronic trading platforms - some of which didn't exist just a few years ago - are now anonymously matching buyers and sellers of hundreds of millions of shares every day. In February of last year, the Commission approved the International Securities Exchange's application to become the first new national securities exchange in twenty-seven years. Now, four entities have applied for registration as an exchange. At the same time, the traditional exchange and over-the-counter markets continue to innovate. Both the New York Stock Exchange and Nasdaq are in the process of incorporating greater automation into their markets, launching complex and important initiatives such as NYSE Direct and the SuperMontage.

No less pressing is our need to keep up with the challenges presented by today's increasingly global marketplace. Companies throughout the world are now seeking capital on a cross-border basis. In addition, U.S. investors today can view real-time quotes from foreign markets, and electronic linkages reduce the costs to U.S. investors of trading directly in foreign markets. These developments make it increasingly important for the SEC to promote high quality disclosure and transparency standards, including high quality internationally acceptable accounting standards.

Despite these long-term needs, our fiscal 2002 request will allow the

Commission to continue such important initiatives as:

- combating the rise in Internet and financial reporting fraud;
- overseeing the securities industry's automation changes in connection with the transition to a T+1 settlement system;
- maintaining our formal inspection cycle program for the increasing number of alternative trading systems;
- updating and improving prospectus requirements for variable insurance products;
- developing a tailored disclosure document for unit investment trusts; and
- addressing developments in domestic and international accounting and auditing matters.

Having outlined our ongoing priorities and how we intend to manage the funding level approved in the President's budget, I would now like to discuss the Commission's severe difficulties in attracting and retaining qualified staff and the status of our pay parity effort.

Staffing Crisis

On June 14, 2001, the House of Representatives voted 404 to 22 in favor of H.R. 1088, the Investor and Capital Markets Relief Act, the companion to S.143, the Competitive Market Supervision Act of 2001, which the Senate passed by unanimous consent earlier this year. Both of these bills would provide the SEC with the authority necessary to match the pay and benefits of federal banking agencies. We currently believe that this legislation will be enacted prior to the start of fiscal 2002 on October 1, 2000. As such, I would like to take this opportunity to review the SEC's current staffing crisis and to discuss the additional resources that we will need to implement pay parity.

As a result of Congress's passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, none of the federal banking regulators is subject to the government-wide pay schedule. As a result, they are able to provide their staffs with appreciably more in compensation and benefits than we can. This disparity is a significant drain on morale. It is difficult to explain to SEC staff why they should not be paid at comparable levels, especially when they are conducting similar oversight, regulatory, and examination activities. It is one thing for staff to make salary comparisons with the private sector, but quite another for them to see their government counterparts making substantially more than they are.

This is particularly true in the wake of the landmark GLBA mentioned above. The GLBA demands that the Commission undertake examinations and inspections of highly complex financial services firms. Moreover, by allowing additional affiliations between securities firms, banks, and insurance companies, the GLBA requires increased coordination of activities among all the financial regulators. Even more so than in the past, Commission staff are working side-by-side with their counterparts from the banking regulatory agencies, including the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance

Corporation. However, we cannot match the salaries that our sister regulators pay.

I appreciate the continued support of our authorizing and appropriating committees and their recognition that pay parity is good public policy. With approximately 3,000 staff, the SEC is small by federal agency standards. This staff is charged with overseeing an industry that includes about 700,000 registered representatives of approximately 8,000 broker-dealers, some 15,000 companies that file reports with us, about 30,000 investment company portfolios, and about 8,000 registered investment advisers. Over $41 trillion in stocks are expected to trade hands this year on the nation's stock exchanges and Nasdaq, including transactions on numerous new electronic communication networks. Mutual funds now hold close to $7 trillion in assets. This is more than double the amount on deposit at commercial banks and surpasses by $2 trillion the total financial assets of commercial banks. Unlike bank deposits, however, mutual fund assets are uninsured and no SROs help us regulate this sector. Social security reform initiatives also raise the possibility of greatly increasing the number of American's invested in our capital markets.

With such important responsibilities and at such a critical time in our markets' development, the Commission simply cannot afford to continue to suffer a serious staffing crisis. Since 1996, our attrition rate has been increasing, particularly among our more senior professionals. Over the last two fiscal years, the Commission has lost 30% of its attorneys, accountants, and examiners.[1] If this trend continues unabated, the Commission's mission of protecting investors and maintaining market integrity will be seriously threatened.

We currently estimate that implementing pay parity will cost approximately $70 million in fiscal 2002, with yearly adjustments for inflation thereafter. This increase brings our revised fiscal 2002 appropriation request to $508 million. While I recognize that this represents a large increase for the Commission, I strongly believe that the most vital resource the SEC has is its highly professional and well-regarded staff and that they ought to be compensated at levels consistent with the other Federal financial regulators.[2] I look forward to working with you to ensure that this additional funding is provided and this issue is resolved.

Fee Reductions

In addition, I would like to take this opportunity to briefly comment on the fee provisions of both S. 143 and H.R. 1088. Both bills would significantly reduce fees for investors, market participants, and companies making filings with the Commission, while preserving the amount of offsetting collections available to this Committee to fund the agency in coming years.[3] These bills also spread the cost of regulation among those who benefit from the activities of the Commission and address the agency's funding structure in a comprehensive and balanced manner. The fee provisions in these bills not only have the support of the SEC, but also of the Administration.

Station Place Lease Procurement

Finally, I would like to provide some additional details regarding the Commission's new headquarters lease. On May 29, 2001 the SEC awarded a

14-year lease for 650,000 rentable square feet at Station Place, adjacent to Union Station, to Louis Dreyfus Properties, LLC, of New York. This decision was made after an extensive two-year procurement during which the Commission held a vigorous competition and consulted with its authorizing committees, appropriations committees, the Public Works Committee, the General Services Administration ("GSA"), the Office of Management and Budget ("OMB"), and the District of Columbia.

The Commission's current headquarters lease at 450 5th Street, N.W. ends in fiscal 2004 and we were required to compete for a new lease pursuant to the Competition in Contracting Act.[4] The SEC has been at this location since 1982 and has been suffering from overcrowding for the last several years. In calendar 2000, we procured additional space at 901 E Street, N.W. and moved several units out of our headquarters to ameliorate overcrowding.[5] While this last move was essential to deal with severe overcrowding, it has negatively impacted the activities of the Commission and reduced our efficiency. In preparing to obtain new space, the SEC sought to consolidate the agency's offices, relieve existing overcrowding, meet safety and health requirements, and ensure adequate access to mass transit. We received a number of proposals and enjoyed a healthy competition. Station Place offered the best means to reach our goals. More specifically, it was the lowest cost, highest technically rated offer in the procurement and represents the best value to the government.

During this procurement, the Commission followed all applicable laws and worked closely with GSA and OMB. From an appropriations perspective, the Commission's award to Station Place was scored as an operating lease and will not require an upfront appropriation of funds to be constructed. Instead, its rental costs will be covered on a yearly basis through our appropriation, much as now. I want to assure you that this move is appropriate for the Commission, good for the city, and the best deal available to the government.

Conclusion

Our nation's markets and the SEC are at a crossroads. New technologies and activities continue to pose new challenges and threats to the integrity of our markets, as does increased globalization. I appreciate the support that this Committee has provided the SEC in the past and look forward to having a fruitful dialogue regarding the resource needs and policy issues that currently face the Commission. I also appreciate the willingness this Committee has already shown in recognizing the need to resolve the SEC's intractable staffing problems. I look forward to working with you toward final passage and funding of pay parity legislation.

Footnotes

[1] Over the past several years the Commission has explored virtually every available approach to keeping staff longer. In 1992, we petitioned and received from the Office of Personnel Management ("OPM") the authority to pay the majority of our attorneys and accountants approximately 10 percent above their base pay. While special pay was a step in the right direction, its value erodes over time and it proved to be a short-term solution. This is because staff that receive special pay do not receive the

government-wide locality increase each year, which means that their special pay becomes less valuable over time and hence becomes less effective as a retention tool. Our appropriation last year included funds to reinstate special pay rates for certain attorneys, accountants, and examiners and OPM recently approved our proposed special pay rates for these employees. While this should help, based on our experience we know that this is at most a temporary and partial remedy to the SEC's staffing crisis. In addition, even with special pay, the salaries at the federal banking regulators are still substantially more than we can pay our staff.

2 A broad cross-section of the securities industry, corporate community, and investor groups have expressed support for pay parity, including the Securities Industry Association, the Investment Company Institute, the Investment Counsel Association of America, the Business Roundtable, the California Public Employees' Retirement System (CalPERS), Teachers Insurance and Annuity Association College Retirement Equity Fund (TIAA-CREF), the National Association of Securities Dealers, the New York Stock Exchange, Fidelity Investments, and the Business Roundtable.

3 The Congressional Budget Office estimates that fees required to be collected by the SEC from all sources will total over $2.47 billion in fiscal 2001. This amount represents more than five times the SEC's enacted fiscal 2001 appropriation of $422.8 million. As stated, both S. 143 and H.R. 1088 are designed to reduce fees while maintaining the amount of offsetting collections that are available to the SEC's appropriators. In fiscal 2002, this amount is estimated at $1.15 billion.

4 The Commission currently has several leases expiring in the regions, in addition to the agency's headquarters lease. We originally signed many of these leases during the late 1980s and early 1990s when prices in the real estate market were depressed and significantly lower than the rates that can be obtained today.

5 The Commission previously moved a large portion of its administrative, information technology, and operations functions out of headquarters and into the Commission's Operations Center in Alexandria, VA in the early and mid 1990s as a first step toward alleviating overcrowding. Those functions will remain in Alexandria after the Commission moves to Station Place.

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